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# Protection of Companies From Shareholder Class Actions Through Constitutional Amendment: Is This Possible Or Desirable?

## **Abstract**

*Companies are increasingly the targets of shareholder class actions for nondisclosure and misleading statements. At least one commentator in the US has argued that liability for such actions might be reduced by amendments to the company's certificate of incorporation. Does the constitution as a statutory contract between shareholders and the company allow elimination or reduction of company liability to shareholders in relation to Australian shareholder class actions? If it does should companies amend their constitution to protect against such actions? The author argues that it is unlikely that company constitutions could eliminate or reduce such liability. On the question of whether companies should attempt to limit liability in this way were it possible, he looks at the financial impact of shareholder class actions and finds mixed evidence.*

## **Keywords**

Nondisclosure; Misleading and Deceptive Conduct; Shareholder class actions; Statutory contract; exclusion clauses; limiting liability

# PROTECTION OF COMPANIES FROM SHAREHOLDER CLASS ACTIONS THROUGH CONSTITUTIONAL AMENDMENT: IS THIS POSSIBLE OR DESIRABLE?

MICHAEL J DUFFY\*

*Companies are increasingly the targets of shareholder class actions for nondisclosure and misleading statements. At least one commentator in the US has argued that liability for such actions might be reduced by amendments to the company's certificate of incorporation. Does the constitution as a statutory contract between shareholders and the company allow elimination or reduction of company liability to shareholders in relation to Australian shareholder class actions? If it does should companies amend their constitution to protect against such actions? The author argues that it is unlikely that company constitutions could eliminate or reduce such liability. On the question of whether companies should attempt to limit liability in this way were it possible, he looks at the financial impact of shareholder class actions and finds mixed evidence.*

## Introduction

Shareholder nondisclosure actions, particularly class actions, are now a significant issue for listed public companies. The ability of one or more shareholders to represent a significant group or class of other shareholders in action against the company in relation to allegations of misleading statements or nondisclosure to securities markets is a concern for companies, their management and other shareholders who may not be in the plaintiff class or group. Given that companies are partly a creature of contract, and particularly given the effect of s 140 of the *Corporations Act 2001 (Cwth)* ('the Corporations Act') in establishing contractual relations between the company and its shareholders (and between the shareholders) the question arises whether a company can contractually reduce or eliminate its liability to shareholders for certain types of conduct. At least one commentator in the United States has made such a suggestion in relation to shareholder actions in that

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jurisdiction<sup>1</sup>. At the outset this appears to be a difficult proposition however it is certainly worth exploring given the stakes involved for the corporation.

### **The rise of shareholder class actions**

Shareholder class actions, whilst not subject to massive growth, do appear to have established themselves as part of the legal landscape in recent times.<sup>2</sup> Several such actions have settled in recent years for significant sums and more actions have begun. These include large settled shareholder class actions against the former GIO, Aristocrat Leisure, Multiplex and AWB<sup>3</sup> as well as settled claims against insolvent entities such as Sons of Gwalia<sup>4</sup> and current actions against Centro, NAB, Nufarm, Oz Minerals Ltd and Elders Limited.<sup>5</sup> ASIC has also been active in investigations in this area and has, inter alia, applied various remedies including enforceable undertakings and compensation in the Multiplex continuous disclosure matter.<sup>6</sup> Such actions typically plead a failure to comply with the continuous disclosure obligations set out in Listing Rule 3.1 and backed up by s 674(2) of the *Corporations Act* as well as breaches of s 1041H of the *Corporations Act* and s 12DA of the *Australian Securities Investments Commission Act (Cth) 2001*.<sup>7</sup> Several of the actions appear also to focus on

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<sup>1</sup> See for instance A C Pritchard, 'Stoneridge Investment Partners v Scientific America: The Political Economy of Securities Class Action Reform, 2007-2008' *CATO Supreme Court Review* 217, 248-255

<sup>2</sup> See the commentary in Michael Legg, 'Shareholder Class Actions in Australia - the Perfect Storm?' [2008] *UNSWLawJ* 1 37; (2008) 31(3) *University of New South Wales Law Journal* 669.

<sup>3</sup> See ASX Media Releases by AMP dated 8 August 2003, Aristocrat Leisure dated 28 August 2008, AWB dated 15 February 2010, Brookfield Multiplex dated 21 July 2010.

<sup>4</sup> See Scheme Administrator's report on Litigation Settlement dated 8 September 2009. See <<http://www.ferrierhodgson.com/en/Current%20Matters/Corporate%20Recovery%20Matters/Sons%20of%20Gwalia%20Limited.aspx>> viewed 11 January 2011.

<sup>5</sup> See generally for instance <<http://www.mauriceblackburnnsw.com.au/areas-of-practice/class-actions.aspx>> viewed 11 January 2011 and <<http://www.slatergordon.com.au/areas-of-practice/victoria/general-legal-services/class-actions/>> viewed 11 January 2011.

<sup>6</sup> See ASIC media release dated Wednesday 20 December 2006 <<http://www.asic.gov.au/asic/asic.nsf/byheadline/06-443+ASIC+accepts+an+enforceable+undertaking+from+the+Multiplex+Group>> viewed 11 January 2011.

<sup>7</sup> The Full Court of the Federal Court has recently given a succinct summary of the relationship between misleading conduct and s 674 continuous disclosure provisions noting that:

'It is sufficient to say that once the misleading statements have been made ... s 674 required that they be corrected.' See *Australian Securities and Investments Commission v Fortescue Metals Group Ltd* [2011] FCAFC 19. Per Keane CJ at [181].

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the company as a defendant without naming officers or others as co-defendants.<sup>8</sup>The significance of the latter point is that, unless the company takes action to join other parties, damages will tend to be funded by the company and therefore the non plaintiff shareholders.

The continued rise of litigation funding is also a factor that may be seen to have continued the further advance of shareholder class actions. Litigation funding was tolerated by the High Court in *Campbells Cash & Carry Pty Ltd v Fostif Pty Ltd*<sup>9</sup> and that tolerance has continued in the recent case of *Jeffery & Katauskas Pty Ltd v Rickard Constructions Pty Ltd*<sup>10</sup> in which the High Court rejected the argument that litigation funding was an abuse of process where it did not provide an adequate indemnity to a plaintiff.<sup>11</sup> More recently, the practice of litigation funding in a class action was found by the Full Court of the Federal Court to constitute the creation of a managed investment scheme requiring registration under the *Corporations Act*.<sup>12</sup> This has been legislatively reversed however, perhaps indicating some level of legislative approval for the function of litigation funding in bringing access to justice.<sup>13</sup>

The rise of shareholder actions raises the issue of whether boards can do anything to protect 'the company' from such actions even though the plaintiffs may be some of the shareholders of that company. As stated, the issue is complicated by the fact that there will be numerous other shareholders of the company who are not plaintiffs in the action. This is so because of the practice of identifying a target plaintiff group of persons who acquired shares over a particular relevant period.<sup>14</sup> That period will usually be chosen with a view to achieving twin targets - the period of the most egregious non disclosures and the largest group of shareholders. This appears to be

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<sup>8</sup> Shareholder class actions that have initially been filed against the company but not officers include *Dorajay Pty Ltd v Aristocrat Leisure Ltd*, *Watson v AWB Limited*, *Hobbs Anderson Investments Pty Ltd v Oz Minerals Ltd*, *Hadchiti and Ors v Nufarm Ltd* and *P Dawson Nominees v Multiplex Ltd*.

<sup>9</sup> (2006) 229 CLR 386.

<sup>10</sup> (2009) 83 ALJR 1180.

<sup>11</sup> See generally the comment in R Baxt 'Litigation funding: Crossing the cross roads' (2010) 28 *C&SLJ* 54.

<sup>12</sup> *Brookfield Multiplex Ltd v International Litigation Funding Partners Pty Ltd* (2009) 180 FCR 11; 260 ALR 643; (2009) 27 ACLC 1610; [2009] FCAFC 147

<sup>13</sup> James Mayanja, 'Enhancing private enforcement of Australia's corporate continuous disclosure regime: Why unshackling litigation funders makes eminent sense' (2010) 25 *Australian Journal of Corporate Law* 48.

<sup>14</sup> Damien Grave, Leah Watterson and Helen Mould, 'Causation, loss and damage: Challenges for the new shareholder class action' (2009) 27 *C&SLJ* 483.

based partly on the economics of running such an action.<sup>15</sup> With increasing acceptance by courts of the 'closed class' in class actions<sup>16</sup> that group of plaintiff shareholders may be effectively reduced further by reference to whether they enter a retainer with a litigation funder or lawyer.

To the extent that 'the company' can do anything to protect itself from such actions the question also arises as to whether the Board should do this or indeed would have any duty to attempt to do this (by way of putting motions before shareholders or otherwise). This raises complicated questions of corporate policy but it should be noted that the courts have generally erred on the side of giving effect to remedial legislation such as that in relation to misleading and deceptive conduct which has 'extended greatly the scope for "shareholder claims" against corporations'.<sup>17</sup> Nevertheless in a time of increasing actions against companies, some of which may even put the solvency of such companies at risk, it is useful to explore this issue.

### **The statutory contract and its origins**

Section 140 of the *Corporations Act* establishes the constitution of the company as a contract between (a) the company and its members; (b) the company and its directors (and company secretary); and (c) members and other members.

The origin of this provision goes back to the *Joint Stock Companies Act 1856* (UK) which abandoned the need for the older deed of settlement and required a memorandum and articles. It was clear that it was necessary to make the memorandum and articles binding even though new members might not sign them so the 1856 Act introduced a provision under which the memorandum and articles, once registered and subject to the other provisions in the *Companies Act*, would bind the company and the members as if they had been signed and sealed by each member. A similar provision applied under companies legislation in the Australian

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<sup>15</sup> Interestingly In the Multiplex class action (*P Dawson Nominees v Multiplex Ltd*) the period of nondisclosure identified by the plaintiffs in the private action was just under ten months - many months longer than the period chosen in the ASIC Enforceable Undertaking action (which was 22 days). See ASIC Media release 06-443 dated 20 December 2006 'ASIC accepts an enforceable undertaking from the Multiplex Group'. <<http://www.asic.gov.au/asic/asic.nsf/byheadline/06-443+ASIC+accepts+an+enforceable+undertaking+from+the+Multiplex+Group?openDocument>> viewed 8 March 2011.

<sup>16</sup> See *Multiplex Funds Management Limited v P Dawson Nominees Pty Ltd* (2007) 164 FCR 275, 284, 299. The Class in that proceeding was limited to persons who 'have, as at the commencement of this proceeding, entered a litigation funding agreement with International Litigation Funding Partners, Inc': 295 (French, Lindgren, Jacobson JJ).

<sup>17</sup> *Sons of Gwalia Ltd v Margaretic* (2007) 231 CLR 160 at [18] (Gleeson J).

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jurisdictions. Austin and Ramsay remark that in retrospect it seems that if the section had never been passed courts could have implied a contract between the members and a contract between the company and each member. They point out that in *Stanham v National Trust of Australia (NSW)*,<sup>18</sup> Young J dealing with a corporation created outside the former *Companies Act* considered that the corporation had entered into a contract with its members despite the absence of any statutory provision deeming a contract to exist.<sup>19</sup> Another case sometimes cited in support of this proposition is *Hickman v Kent or Romney Marsh Sheep Breeders Association*<sup>20</sup> where the association in question was an incorporated non-profit company. A clause in the company's articles/constitution required disputes to be referred to arbitration and this was found to be binding on Mr Hickman, a member.

The firm as a contract between shareholders, between the company and shareholders and between the company and directors<sup>21</sup> arguably also fits within the theoretical construct of the firm as a 'nexus of contracts'. The nexus of contracts view is that the firm is not really an individual but is a form of legal fiction which serves as a nexus for contracting relationships. This goes wider than the s 140 formulation as there is said to be a multitude of complex relationships (ie contracts) between the legal fiction (the firm) and the owners of labour, material and capital inputs and the consumers of output.<sup>22</sup> Though identifying these various constituents the proponents of the nexus of contracts view generally adopt a shareholder centred view of the corporation. It is said that despite the fact that corporations are merely complex webs of contractual relations and despite the fact that shareholders may not 'own' the publicly held firm in any meaningful sense, the ultimate right to guide the firm (or to have it guided on their behalf) is retained by the shareholders because they are the group that values it most highly.<sup>23</sup> The issue being discussed in this paper cannot really be resolved by the nexus of contracts model as it is ultimately a dispute between one group of shareholders and another group. Though the nexus of contracts view suggests that (according to Easterbrook and Fischel), a court ought to imply the 'term [that] ...

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<sup>18</sup> (1989) 15 ACLR 87; 7 ACLC 628.

<sup>19</sup> Austin and Ramsay *Ford's Principles of Corporations Law* at para 6.020 (looseleaf).

<sup>20</sup> [1915] 1 Ch 881.

<sup>21</sup> Though shareholders and directors do not directly contract with each other under s 140 or otherwise.

<sup>22</sup> M C Jensen and WH Meckling, 'Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure' (1976) 3 *Journal of Financial Economics* 305, 311.

<sup>23</sup> J R Macey, 'An Economic Analysis of the Various Rationales for making Shareholders the Exclusive Beneficiaries of Corporate Fiduciary Duties' (1991) 21 *Stetson L Rev* 23. Extracted in Franklin A Gevurtz, 'Corporate Law Anthology' (1997 Anderson Publishing Co Cincinatti) 168.

increase[s] the joint wealth of the participants—that is, ... the term that the parties would have selected with full information and costless contracting<sup>24</sup> this may be difficult as it suggests that the parties would have reached an agreement over such matters when in fact it may be that, absent court intervention, they never would have.

The other factor that may have some relevance to the contractual view is that the rights provided under s 1041H and s 674 of the *Corporations Act* and s 12DA of the *Australian Securities and Investments Commission Act 2001 (Cth)* are not rights that are exclusive to shareholders. Rights to damages under s 1041H are available to ‘a person who suffers loss or damage by conduct of another person’ under s1041I of the *Corporations Act*. Rights to damages under s 674 are available to ‘a person ... for damage suffered by the person’ pursuant to s 1317HA of the *Corporations Act*. Rights to damages under s 12DA are available to ‘a person who suffers loss or damage by conduct of another person’ under s 12GF. It follows that the rights to damages are in no way related to the statutory contract,<sup>25</sup> the membership of the corporation and the ownership of shares (though the ownership of shares at some point may have provided the occasion for the cause of action to arise).

### **Excluding liability**

Members may adopt a constitution at the date of registration by consenting in writing to be bound by the constitution or after registration by special resolution.<sup>26</sup> Given the existence of the constitution as a statutory contract, it may, theoretically at least (and on the highest view of the constitution as a statutory contract), be open to members to contractually agree amongst themselves and with the company in the constitution that they will prospectively limit the company’s exposure to damages claims by shareholders in relation, in particular, to nondisclosure actions to shareholders. Whilst there are some difficulties with purporting to completely exclude statutory causes of action (this cannot be done with misleading conduct under s 52 of the *Trade Practices Act 1974 (Cth)* for instance<sup>27</sup>) there is the possibility of exclusion clauses which may operate against tortious claims and the general power to contractually settle and compromise all claims<sup>28</sup> and the issue is the extent to which this might be done prospectively in a constitution. It is not known whether

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<sup>24</sup> See Easterbrook & Fischel, ‘The Corporate Contract’ (1989) 89 *Colum L Rev* 1416, 1433.

<sup>25</sup> Unless an implied or special contract is to be argued where the contractor agrees to abide by all terms of the *Corporations Act*.

<sup>26</sup> *Corporations Act 2001 (Cth)* s 136.

<sup>27</sup> *Henjo Investments Pty Ltd v Collins Marrickville Pty Ltd* (1988) 79 ALR 83

<sup>28</sup> *Pacific Parking Pty Ltd v Ryssal Three Pty Ltd* (1995) ATPR (Digest) 46-142. Though this really relates to settling claims after they have occurred.



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there is any contractual right to exclude by agreement a breach of s 674 of the *Corporations Act* however it seems likely that this would follow the position for misleading and deceptive conduct and not be susceptible to exclusion.

### **Otherwise limiting liability**

Beyond outright exclusion, however, shareholders and the company may attempt to agree to a formula for loss calculation that caps or limits loss or calculates it by reference to a formula that limits the quantum of their claims. There is authority<sup>29</sup> to suggest that this is permissible in the case of contractual losses (though there is the counter argument that a fundamental breach or repudiatory conduct that ends the contract may also end the operation of such clauses to limit losses). The question of limiting or capping losses is clearly more problematic in relation to losses for breaches of statutory duties.<sup>30</sup> Though it has been effective for tortious loss it seems to be more difficult for statutory contraventions. In Canada caps to losses have been applied by legislation<sup>31</sup> and this was also an option considered in Australia in the CAMAC enquiry into the *Sons of Gwalia* decision.<sup>32</sup> It has also been argued for in the United States.<sup>33</sup>

### **Other forms of limitation of liability**

Besides outright exclusion or capping, other means by which damage might be limited might be by a term in the constitution that there be a direct reliance requirement for causation of loss from any misleading and deceptive conduct. This would mean that shareholders would have to rely directly on the misleading statements or nondisclosures to establish loss. This appears to have been required by

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<sup>29</sup> Some of the text book writers appear to accept the possibility. See Atyah and Others (eds) *Chitty on Contracts*, Sweet & Maxwell Ltd 1977 citing the case of *Cellulose Acetate Silk Co Ltd v Widnes Foundry* (1925) Ltd [1933] AC 20 but noting in contradiction the cases of *Diestal v Stevenson* [1906] 2 K B 345; *Biggin & Co Ltd v Permanite Ltd* [1951] 1 KB 422 436 and *Elphinstone v Monkland Iron and Coal Co* (1886) 11 App Cas 332, 346.

<sup>30</sup> It is likely for instance that claims under s 1041H of the *Corporations Act* and 12 DA of the ASIC Act would follow the law in relation to s 52 of the *Trade Practices Act* and not be excludable or reducible by contract.

<sup>31</sup> The laws cap damages payable by the issuer company at the greater of 5 per cent of the issuer's market capitalization or \$1 million. The caps will not apply where a person made a misrepresentation or on disclosure with knowledge that it was a misrepresentation or non disclosure. See S138.5-138.7, RSO 1990, c S-5.

<sup>32</sup> Corporations and Markets Advisory Committee (CAMAC) *Shareholder Claims against Insolvent Companies- Implications of the Sons of Gwalia decision*. Report December 2008, 105.

<sup>33</sup> D C Langevoort, 'Capping Damages' (1996) 39 *Arizona Law Review* 639.

courts in any event in Australia in the recent cases of *Digi-Tech (Australia) Pty Ltd v Brand*<sup>34</sup> and *Ingot Capital Investments Pty Ltd v Macquarie Equity Capital Markets Ltd*<sup>35</sup> however was not required in the older case of *Janssen-Cilag Pty Ltd v Pfizer Pty Ltd*<sup>36</sup> and is opposed to one school of thought which is more in line with the US 'fraud on the market' theory. The latter theory posits that shareholders do not need to rely directly on actual misstatements as long as they rely on the accuracy and integrity of the market price when they purchase shares (ie they assume that the market price is accurate and has not been corrupted by misinformation or nondisclosure of relevant disclosable data).<sup>37</sup> The result is that they can therefore claim the difference between what they paid for shares with what the shares would have traded at had negative news been disclosed when it should have been disclosed. This area is currently controversial<sup>38</sup> and the law is uncertain but it is arguable that one possible way to achieve certainty would be by contractual 'agreement' enshrined in the constitution.

Another means by which damages might be limited is by constitutionally setting the standard of damages as disgorgement rather than common law damages.<sup>39</sup> This has been suggested in the United States in the context of shareholder class actions there but there is some disagreement as to whether this can be done in that jurisdiction.<sup>40</sup> On the one hand Black argues that the anti-waiver clause of s 29(a) of the *Securities Exchange Act of 1934* and US state law would both prevent this proposal. Section 29(a) provides that 'any condition, stipulation or provision binding any person to waive compliance with any provision of this Act or of any rule or regulation thereunder ... shall be void.' Pritchard by contrast argues that such a change to the company's

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<sup>34</sup> (2004) 62 IPR 184.

<sup>35</sup> (2008) 252 ALR 659.

<sup>36</sup> (1992) 37 FCR 526.

<sup>37</sup> See generally Damien Grave, Leah Watterson and Helen Mould, 'Causation, loss and damage: Challenges for the new shareholder class action' (2009) 27 *C&SLJ* 483, Andrew Watson and Jacob Varghese, 'The case for market based causation' (2009) 15(2) *UNSW Law Journal* 948, 'Fraud on the market: Judicial approaches to causation and loss from securities nondisclosure in the United States, Canada and Australia' [2005] 29(3) *Melbourne University Law Review* 621.

<sup>38</sup> See Ross Drinnan and Jenny Campbell, 'Causation in Securities Class Actions' (2009) 15(2) *UNSW Law Journal* 928, Mark Humphery, 'When does "fraud on the market" induce a right to damages?' (2010) 35(2) *Monash University Law Review* 422.

<sup>39</sup> The disgorgement proposal has been advanced in the United States by Professor Adam Pritchard and Professor John Coffee. See for instance A C Pritchard, above n 1, J Coffee, Jr., 'Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation' (2006) 106 *Columbia Law Review* 1534.

<sup>40</sup> See Barbara Black 'Eliminating securities fraud class actions under the radar' *Colum Bus L Rev* 2009 (3), 802.

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certificate of incorporation would be sufficient notice of waiver to bind subsequent purchasers of shares.<sup>41</sup> The debate rages on in that jurisdiction where common law damages have been subject to considerable criticism as they are said to be difficult to estimate (which impedes settlement) and ineffective because the size of the damage awards are not correlated to the social costs of the violation.<sup>42</sup>

In the Australian context a similar proposal could be terms in the constitution that the measure of damages for breach would be analogous to an equitable account of profits rather than common law damages. This would deprive the company and its directors of the fruits of any nondisclosure or misleading conduct (such as a capital raising based upon misleading disclosure) while not exposing the company and its directors to the substantial damages that might accrue based on mispriced secondary trading during a lengthy period of nondisclosure or misstatement.<sup>43</sup> In the US this has been argued for on the basis that deterrence is the principal justification for shareholder class actions.<sup>44</sup>

All of these suggestions should be treated with caution however given the likelihood that misleading and deceptive conduct and continuous disclosure claims are likely not susceptible to contractual limitations on damages.

### **‘Ratification’?**

Ratification is a doctrine that strictly involves the company ratifying breaches of duty by officers through a majority vote of members. The doctrine of ratification originated in fiduciary law. The principle was that an agent’s lack of authority could be rectified by the principal later ratifying the act. The sort of ‘ratification’ to be discussed here is on one view not ratification at all but votes by members which may affect the ability of other members to sue the company.<sup>45</sup> I use the term however for convenience and because the proposal discussed does involve a form of voting by a

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<sup>41</sup> Pritchard above n 1, 252.

<sup>42</sup> See Janet Cooper Alexander, ‘Rethinking Damages in Securities Class Actions’ (1996) *Stanford Law Review* 48: 1487.

<sup>43</sup> Such amounts could be substantial in a highly traded stock where a nondisclosure runs over several months. This is because everyone who purchased the stock in the period may have paid more than the true value of the stock. This loss cannot however practically be offset by the gains of those who innocently sold the stock for overvalue in the period concerned.

<sup>44</sup> Pritchard above n 1, 249.

<sup>45</sup> The concept of one group of shareholders affecting the rights of another shareholder through ratification is not unknown given that a director whose conduct is ratified may also be a shareholder.

majority of shareholders to impart forgiveness for otherwise actionable conduct. Thus, characterising the constitution as a contract between shareholders, shareholders might also attempt to amend the constitution in a manner that might allow later ratification or forgiveness of the company by the shareholders for nondisclosing conduct where this is supported by a majority of voting shareholders (the 'forgiveness' may prevent action by shareholders for the nondisclosures but not action by other third parties who are not a party to the statutory contract). Majority ratification has a number of difficulties however where the shareholders being deprived of their rights vote against the proposal (as they may argue for instance that they are being oppressed). Ratification may also be relevant to the other forms of limitation of liability as later ratification could be attempted to accompany any reliance upon a term of the constitution excluding or limiting loss after the conduct has occurred. In this way shareholders could be fully informed and there would be no issue of prospective approval of something that has yet to occur. Because true ratification involves the tyranny of the majority over individual rights it is however subject to a number of limitations. These were summarised by Santow J in *Miller v Miller*<sup>46</sup> where his Honour said:

Ratification is not available where it would constitute a fraud on the minority, a misappropriation of company resources, or was entered into by an insolvent company to the prejudice of creditors or defeated a member's personal right or was oppressive or where the majority in general meeting acted for some improper purposes as directors

Use of ratification might involve use of a prior constitutional amendment whereby shareholders specifically agree that misleading or nondisclosure by the company might be cured by later 'ratification' by a majority vote of members in general meeting. Thus there would be a constitutional amendment at the outset flagging the possibility of later ratification (and requiring a special resolution of shareholders to pass) as well as the later ratification itself passed by a majority of shareholders. As noted there may be a problem where the contravention sought to be ratified is not in the nature of breach of a duty owed to the company. Further, where the breach is of a statutory obligation, this has also presented various problems for ratification. It appears to raise some of the issues traversed in *Forge v ASIC*<sup>47</sup> in which the NSW Court of Appeal held that shareholders could not ratify a breach of the statutory duties imposed upon directors by ss180-184 of the *Corporations Act*. To similar effect was *Angas Law Services Pty Ltd (in liq) v Carabales*<sup>48</sup> where two judges of the High

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<sup>46</sup> (1995) 16 ACSR 73 at 89.

<sup>47</sup> (2004) 213 ALR 574.

<sup>48</sup> (2005) 215 ALR 110.

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Court found that a majority of shareholders could not release the directors from their statutory duties.

Ratification clearly applies to directors' duties owed to the company. Whether it applies to obligations owed by the company to a group of shareholders is a different question. The doctrine of ratification is necessarily about injuries to the company and not to any group of shareholders so it seems likely that the company cannot forgive such a breach. Whether, pursuant to the statutory contract between shareholders one group of shareholders can force another group of shareholders to forgive a breach by the company by a majority vote of the company's shareholders seems somewhat unlikely as well, even if provided for in the constitution as an agreement between shareholders.<sup>49</sup> Further, ratification has been said to be ineffective to affect a shareholder's personal rights which might include a right of action for damages pursuant or incident to ownership of shares.

Where the doctrine of ratification may have some relevance would be in relation to any breach of fiduciary duties (though probably not statutory duties) by officers consequent on a breach of continuous disclosure obligations. Such breaches has been found to follow in the recent cases of *Australian Securities and Investments Commission v MacDonald and Ors*<sup>50</sup> and *ASIC v Fortescue Minerals Group*<sup>51</sup> (see below) where continuous disclosure breaches or misleading statements were found to breach duties to the company because they exposed it to civil penalty contraventions. It does seem unlikely however that a company could be found to have engaged in such contraventions but that its management would then be exonerated from breach of their fiduciary duties.

### **Other problems with the proposals**

A number of other general difficulties with all these proposals also appear to exist at the outset.

1. Consideration. Some basic contractual principles may intrude here. The nature of the statutory contract is that it exists without consideration and can be altered by the members without consideration. It is not entirely clear whether consideration

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<sup>49</sup> Though it has been asserted that ratification operates only to bind shareholders themselves and not the company more broadly and that this may in any event be changed if there is an alteration in ownership or control of the company. See Alice Ashbolt, 'Legislated and reasoned away: Death of the doctrine of shareholder ratification' (2009) 83 *Australian Law Journal* 525, 528.

<sup>50</sup> (2009) 256 ALR 199.

<sup>51</sup> [2011] FCAFC 19.

exists for any such releases/limitations nor whether it is required to exist. This is also a problem given the amount of the claim which is to be released is unknown. By the same token it is also not clear whether consideration is required to enforce terms of the statutory contract given its special nature. Though it has been held that the corporate constitution should be given a businesslike interpretation and construed so as to give it reasonable business efficacy the rules applicable to and for construction of commercial contracts are not always directly applicable.<sup>52</sup> As to existence of consideration, the acquisition of shares does involve payment of consideration though, apart from the initial allotment, this consideration passes to the vendor of the shares (who is exiting as a shareholder) rather than to the company so it may be problematic as consideration as between shareholders or as between the company and shareholders.

2. Section 140(2). Section 140(2) makes it clear that unless a member of a company agrees in writing to be bound, they are not bound by a modification of the constitution made after the date on which they became a member so far as the modification increases the member's liability to contribute to the share capital of, or otherwise to pay money to, the company. The release of the company from a debt or right of action might arguably be viewed as a payment of money to the corporation by the aggrieved shareholder (though this is by no means certain). In *Ding v Sylvania Waterways Ltd*<sup>53</sup> Austin J said that s 140(2) also applied to any special contract containing an implied term authorising amendments which increase a member's liability to pay any money to the company and overrides any such term except where the member had assented to it in writing.

### **Limits on the statutory contract**

An additional difficulty for the proposals is common law that relates to the question of what the deemed contract between the company and its members relates to. In *Eley v Positive Government Security Life Assurance Co*<sup>54</sup> an attempt to enforce the statutory contract by a member in an outside capacity (he was also solicitor to the company) was unsuccessful. This was because the deemed contract only related to enforcement of the member's rights in his capacity as a member and not in some other outside capacity. In the case of a constitution limiting liability of the company it is the company seeking to assert the right against the member rather than the other way around as occurred in *Eley*. The question may still arise however as to whether

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<sup>52</sup> *Lion Nathan Australia Pty Ltd v Coopers Brewery Ltd* (2006) 156 FCR 1; 236 ALR 561.

<sup>53</sup> (1999) 46 NSWLR, 150 FLR 239.

<sup>54</sup> (1875) 1 Ex D 20.

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the contract to release or limit the company's liability to members affects the rights of members of the company as members or in some other outside capacity.<sup>55</sup>

This was in some sense, though in another context, some of the territory covered in *Sons of Gwalia v Margaretic*.<sup>56</sup> In that case shareholders made claims against the company for misleading and deceptive conduct and breaches of continuous disclosure obligations (just the sort of claims that companies might seek to protect themselves from as discussed in this article). The main question in that case was whether shareholder claims should be postponed behind other creditor claims under s 563A of the *Corporations Act*. That section talked about postponement of debts owed to persons in their capacity as members until all other creditors had been paid. To decide the question the High Court was required to identify whether debts due to shareholders on their litigious claims were incurred 'in their capacity as members'. The court found in fact that the claims were made pursuant to various statutory provisions for consumer protection and were not claims made by the shareholders in their capacity as members. They therefore were not postponed by s 563A. If this authority were applied to the principle in *Eley* it might be argued that the deemed statutory contract/constitution purporting to limit damages claims related to claims of shareholders not in their capacity as members and that the company was seeking to impose this on them in some outside capacity rather than as a shareholder.

The recent statutory overturning of the *Sons of Gwalia* decision<sup>57</sup> does not overturn the finding that shareholder nondisclosure claims are not made 'in their capacity as members' but rather specifically postpones these other types of claims as well. It would therefore not affect the above analysis.

### **Changing the constitution**

Further, difficulties may arise in taking action to change the company constitution to implement any constitutional provisions designed to limit shareholder loss.

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<sup>55</sup> This is the interpretation put on *Eley* in most legal reference books and in the later decision of *Hickman v Kent or Romney Marsh Sheep-Breeder's Association* [1915] 1 Ch 881. Some commentators have made the point that *Eley* in fact did not discuss *Eley's* status as a shareholder and therefore does not really address the point that it is said to be authority for. Nevertheless, the orthodox interpretation has been applied in Australia. See *Morris v Hanley* (2003) 173 FLR 83; [2003] NSWSC 42 at [79] per Hamilton J.

<sup>56</sup> [2007] HCA 1.

<sup>57</sup> See Corporations Amendment (No 2) Bill Exposure Draft 19/04/2010.

### The *Gambotto* principles

Under the High Court's seminal decision in *Gambotto v WCP*<sup>58</sup> the Court (Mason CJ, Brennan, Deane and Dawson JJ delivering a joint judgment with McHugh delivering a separate judgment that agreed in the result) the majority made it clear that a constitutional amendment in relation to the company constitution that allowed for the expropriation of shares from shareholders should be both 'fair' and 'for a proper purpose'. Fairness entails that shareholders who (in that case) had their shares expropriated, should be paid the fair value of those shares as compensation. 'A proper purpose' entailed value judgments about what was proper and in the company's interests.

It is possible that this authority might be applied to constitutional amendments which involve other forms of expropriation from shareholders. Clearly a constitutional amendment that eliminates or reduces the liability of the company to some shareholders might be an amendment that the *Gambotto* authority might have some relevance to. The decision after all talks in terms of amendments allowing expropriation of valuable property rights attaching to shares. Clearly causes of action for misleading conduct or non disclosure in relation to shares are choses in action and might on one view be said to 'attach' to the shares (ie without having at some point owned an interest in the shares, the shareholders would not have the causes of action). The fairness requirement would seem to entail that shareholders be fairly compensated for what they are giving up. This is obviously impossible to know in advance in the case of releasing or excluding future shareholder actions so it may be difficult to satisfy this requirement. It also would of course defeat the purpose of such a constitutional amendment if shareholders were paid out compensation equivalent to the (maximum) value of their damages claims as this is what the amendment seeks to avoid.

As well as identifying expropriation the *Gambotto* decision also identified limits on the ability to alter the constitution that might give rise to a conflict of interests. In relation to these types of amendments the court indicated that such amendments would be prima facie valid unless they could be shown to be beyond any purpose contemplated by the constitution (and therefore ultra vires) or oppressive.<sup>59</sup> An amendment affecting the rights of one group of shareholders who happened to be claimants in a group or other action against the company is undoubtedly an amendment affecting the rights of a minority of shareholders. Whether same would be oppressive is arguable - this type of matter does not fit within the usual categories of oppression (though these are hardly closed). It has however been held that

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<sup>58</sup> (1995) 182 CLR 432; 16 ACSR 1.

<sup>59</sup> *Gambotto v WCP* (1995) 182 CLR 432; 16 ACSR 1 at 9.



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conduct may be oppressive and unfairly prejudicial notwithstanding that it is in accord with the company's constitution. This occurred in *Sutherland v NRMA*<sup>60</sup> where a compulsory retirement age in the constitution was found to be unfairly prejudicial or unfairly discriminatory against the applicant. Further, one of the remedies for oppressive conduct available under s 233 of the *Corporations Act* is modification of the company constitution which obviously suggests that a constitutional provision could itself be oppressive and that an alteration of the constitution might well amount to oppressive conduct. Lastly, oppression applies whether the conduct affects the person in their capacity as a member or otherwise. We have already discussed the issue of whether such shareholder claims arise in the capacity of members or not (concluding on the basis of *Sons of Gwalia* that they do not).

Certainly changes to the constitution affecting existing rights would be more likely to be oppressive than provisions that already existed when shareholders acquired their shares. The latter may indeed amount to part of the legitimate expectations<sup>61</sup> of parties when the company was formed which would make it less likely that the provisions were oppressive. The issue of notice may arise in the latter situation though generally new shareholders do not need to be specifically notified of matters in the corporate constitution and generally take shares subject to the terms set out in the corporate constitution including, for instance, the company's right to make calls (which similarly exposes members to a financial burden).

The other aspect of *Gambotto* is the doctrine of proper purpose (at least in relation to expropriation of shares). Whether an amendment of the type discussed is for a proper purpose may raise the question of whether it was in the company's interest to defeat or limit the quantum of such shareholder claims. This enquiry should be made cautiously however as the majority in *Gambotto* specifically preferred the 'proper purpose' test to the test of whether an amendment was made 'bona fide for the benefit of the company as a whole.'<sup>62</sup> Nevertheless, it is submitted that the benefit to the company must still be part of that wider enquiry. This raises wide issues and is not an easy question to answer.<sup>63</sup> From the company's point of view however, one of the issues to be considered would likely be the extent to which the company was able

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<sup>60</sup> (2003) 47 ACSR 428.

<sup>61</sup> See *O'Neill v Phillips* [1999] 2 All ER 961; [1999] 1 WLR 1092.

<sup>62</sup> Which had been the test in the older authority of *Allen v Gold Reefs of West Africa* [1900] 1 Ch 656.

<sup>63</sup> The 'proper purpose' test in *Gambotto* was subject to some criticism which saw it partly modified by statute in the context of compulsory acquisition of shares. See for instance Jeanne Cilliers and Stephanie Luiz, 'Comments on the test determining the validity of an alteration of articles of association' (1999) 11 *Australian Journal of Corporate Law* 89.

to deflect such claims from its owners, the shareholders, and place the burden of such claims more squarely on its directors and officers who may themselves have been responsible for the misleading statements or nondisclosures. To obtain indemnity from those officers however it will be necessary to answer the question of the extent to which those officers have duties to the company to ensure that the company complies with its continuous disclosure obligations. In *Australian Securities and Investments Commission v MacDonald and Ors*<sup>64</sup> a draft announcement to the Australian Securities Exchange (ASX) was alleged to have been considered and approved by the Board of James Hardie Industries limited. The statement (about asbestos liabilities and provisions) was found to be misleading and ASIC had taken action against officers of James Hardie in relation to alleged breaches of duties in their decision to publish the statement. The Court found that the officers of James Hardie should have known that the company may face legal action for misleading conduct if the statement was misleading and their approval of the ASX announcement was therefore a breach of their directors duties under s180 of the *Corporations Act*.

Similarly in *ASIC v Fortescue Minerals Group*<sup>65</sup> the court found that Andrew Forrest the managing director of Fortescue Minerals Group was involved in misleading conduct by that company contrary to s 1041H and involved on non disclosures contrary to s 674. The court found that he therefore breached s 180(1) of the Act in exposing FMG to pecuniary penalties.

It follows from the *Fortescue Minerals* and the *MacDonald* authority that disclosure breaches by the company may also entail directors duties breaches and this would raise the theoretical possibility of a company, when sued by its shareholders in relation to same, itself making indemnity claims against those directors who were in breach of their duties and thereby having access to their insurance. This would reduce the deleterious impact of such claims as regards the company's (and the shareholders') funds.

Thus, though on first blush it may appear that an exclusion clause or release may be in the company's interests as it might reduce any potential liability the company has to make payment to aggrieved shareholders, there may be more complicated arguments based on *ASIC v MacDonald* and *ASIC v Fortescue Metals Group* that the deleterious effect on the company may be avoided if it brings action against its directors, officers or others involved in the breach.<sup>66</sup> As already mentioned the

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<sup>64</sup> (2009) 256 ALR 199.

<sup>65</sup> [2011] FCAFC 19.

<sup>66</sup> Indeed, if such proceedings were not brought by the company (which might be practically expected as the board might be loath to sue its own members), then such action would also be available to the plaintiff by way of derivative action. Whilst this would benefit the

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possibility also arises that if such a clause were enforceable, the directors might be under a positive duty to seek to insert such a clause in the constitution and to put this before shareholders. Much of this would appear to be a matter of conjecture however as it seems more likely that such clauses are not enforceable.

**Fraud on the minority?**

Alteration of the company constitution to limit or eliminate liability to shareholders for misleading statements or nondisclosure could also fall foul of the doctrine of fraud on the minority of which the Gambotto decision forms a part. The doctrine was stated by Dixon J in *Peters American Delicacy Company Ltd v Heath*<sup>67</sup> to invalidate an apparently regular use of a power which is really 'a means of securing some personal or particular gain, whether pecuniary or otherwise, which does not fairly arise out of the subjects dealt with by the power and is outside and even inconsistent with the contemplated objects of the power.'<sup>68</sup> In other contexts such an abuse has been described as the majority voting 'outside the fair scope of the social contract'<sup>69</sup> as well as not in accord with the interests of the company as a whole. One of the issues here would be the effect on shareholders who were aware of the provision in the constitution or at least became shareholders after the amendment to the constitution versus the effect on those who were already members before the amendments and whose rights were affected by the amendments. Clearly such amendments are more likely to be a fraud on the latter minority than the former minority.

**Is it 'in the company's interest' to seek to protect a company from shareholder class actions or to allow shareholders to pursue such claims?**

One means of answering this question is to examine the degree to which shareholder class action settlements are funded by the company as opposed to third party recoveries. This is an important issue as, to the extent that the company funds these settlements it is the non plaintiff shareholders who are paying so that this becomes an issue of equity as between shareholders. There is little empirical data on this question but what there is appears to be equivocal. I have collected details of a number of the substantial class action settlements and examined the extent to which they were funded directly by the company and by other recoveries.

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company and its shareholders, the practical advantage to the plaintiff in bringing concurrent derivative action however is not entirely clear.

<sup>67</sup> (1939) 61 CLR 457.

<sup>68</sup> *Peters American Delicacy Company Ltd v Heath* (1939) 61 CLR 457, 511.

<sup>69</sup> *Dutton v Gorton* (1917) 23 CLR 362 at 395.

- (a) The first substantial shareholder class action settlement in Australia was that reached in the matter of *King v GIO and others*. The press release from AMP (the parent company of GIO) announcing the settlement states that out of a total settlement sum of \$112 million, the parent company of GIO would be contributing \$56.8 million or just over 50 per cent.<sup>70</sup> This would suggest that other recoveries from other defendants (which included directors and a merchant bank) amounted to just under half the settlement sum.
- (b) In the shareholder class action of *Dorajay v Aristocrat Leisure Ltd* the settlement sum was said to be \$144.5 million<sup>71</sup> but according to Aristocrat's ASX release, the net cost to the Aristocrat group was said to be limited to a net cost after expenses and tax of some \$40 million.<sup>72</sup> This therefore appears to indicate substantial recoveries from other non specified parties (possibly including some officers and their insurers and others though the plaintiff sued the company only).
- (c) In the shareholder class action of *Watson v AWB Limited* the ASX release states a settlement sum of \$39.5 million of which 100 per cent appears to derive from the company AWB Limited.<sup>73</sup>
- (d) In the shareholder class action of *Dawson v Multiplex* the ASX release from Brookfield Multiplex Funds Management Ltd indicated a settlement sum of \$110 million but that 'the settlement amount has been funded by recoveries from third parties'.<sup>74</sup> The amount of those recoveries is not stated so it is therefore not known how much came from the original defendants Multiplex Ltd and Brookfield Multiplex Funds Management Ltd.
- (e) In the shareholder class action against Telstra Corporation limited 100 per cent of the \$5 million settlement appears, from its media release, to have been paid by Telstra Corporation.<sup>75</sup> There are no details of any recoveries.
- (f) In shareholder claims made against Sons of Gwalia Ltd the entire settlement amount of \$178 million (encompassing both shareholder claims and other claims) came from other recoveries from auditors and others however this was hardly surprising given the insolvency of the Sons of Gwalia Ltd entity.<sup>76</sup>

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<sup>70</sup> AMP ASX Release n 3 above.

<sup>71</sup> Maurice Blackburn Lawyers website n 5 above.

<sup>72</sup> Aristocrat Leisure Ltd ASX release n 3 above.

<sup>73</sup> AWB ASX release n3 above.

<sup>74</sup> Brookfield Multiplex ASX release n3 above.

<sup>75</sup> Telstra Corporation ASX release dated 12 November 2007.

<sup>76</sup> Ferrier Hodgson Scheme Administrator's report n 4 above.

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- (g) Other shareholder class action settlements such as Harris Scarfe, Village Life and Downer EDI are partly confidential and do not appear to have publicly available data on these matters.

In summary then, companies' funds are partly depleted by shareholder class actions but arguably not to a significant extent. In the larger settlements there appear to be a healthy level of recoveries being generated from third parties who may include directors and officers, consultants, auditors and the insurers of all of these. Whether this data provides evidence that moves to protect a company from such actions are 'in the company's interest' is arguable.

### **Conclusion**

The rise of shareholder class actions may tempt companies to look at protective measures such as provisions in their constitutions that limit the effect of such actions by purported statutory agreement amongst shareholders and between the company and shareholders. Such measures might include limiting damages by various means and/or forgiveness of the company by release or by later shareholder vote to that effect ('ratification'). All of these possibilities face significant hurdles including probable inability to limit damages for statutory claims and lack of ability to impose these types of burdens or obligations under the statutory contract. There will also be problems with making the necessary constitutional amendments which may not be seen to be fair or for a proper purpose and may in addition appear to be oppressive on the minority. It also seems likely that the doctrine of ratification of breaches of duty by a majority of shareholders will not apply in this situation. To the extent it were possible to adopt such protective measures the evidence is mixed as to whether it is in the interests of companies and their shareholders to do so or whether companies currently adequately offset the effect of such shareholder actions on their remaining shareholders by recoveries against officers and third parties.